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E.O. 12958: DECL: 08/03/2031
TAGS: [ENRG](#) [ECON](#) [PREL](#) [LH](#) [XG](#) [VE](#) [LY](#)
SUBJECT: LITHUANIA'S CHOICE: FIGHT OR SURRENDER ITS
REFINERY TO THE RUSSIANS

REF: A. VILNIUS 711 AND PREVIOUS
[B](#). VILNIUS 285
[C](#). WARSAW 1336

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Classified By: Economic Officer Scott Woodard for reasons 1.4 b and d

[1](#)1. (S) SUMMARY: Lithuania and its Mazeikiu Nafta (MN) oil refinery need to decide how to proceed, now that an "accident" has resulted in a complete cutoff in the refinery's pipeline-delivered supply of Russian crude. State Department Advisor Steve Hellman framed this issue for the Lithuanians during his very timely and helpful visit, and sketched out strategies and tactics that Lithuania can employ if it chooses to resist this apparent Russian attempt to squelch the sale of MN to Poland's PKN Orlen and ensure that the refinery ends up in Rosneft's hands. MN's leadership says that it can supply the refinery profitably by tanker, and the GOL seems willing to support this effort. Lithuanian officials very much appreciated Hellman's visit (and the USG's willingness to send him), and clearly intend to lean on his industry expertise as they manage the challenge ahead.
End Summary.

ASSESSMENT OF CURRENT SITUATION

[1](#)2. (S) During his August 2-3 visit to Lithuania, State Department Advisor Steve Hellman told his interlocutors that MN should not expect any crude shipments via pipeline in the foreseeable future. He said that, according to his sources in Russian industry and government, the Kremlin -- specifically Igor Sechin, Rosneft's chair and Deputy Head of Russia's Presidential Administration -- had ordered MN's supply cut off and that the end-of-July pipeline "accident" near Bryansk, Russia was in fact the execution of this order. Hellman advised that influential Russians openly spoke of MN as "Rosneft's refinery" and that members of Russia's "oil vertical" (nefti vertikal) believed that "their" share of this bit of Yukos's former empire amounts to USD 3 billion, which they intended to start collecting by taking over the refinery. The crude cutoff, Hellman said, was the first step

of the Russians' plan. No amount of negotiation or diplomatic pressure at any level, Hellman advised, would result in a re-opening of the pipeline to MN at this time. (Note: The Lithuanian press, citing Transneft officials, reports that the damage to the pipeline will take 9-12 months to repair.)

13. (S) Underlying the Russians' strategy, Hellman said, is the belief that MN cannot supply itself without the pipeline. Hellman added that not all members of the Russian oil elite share this view, specifically citing various Transneft officials and other technical experts, but emphasized that those who believe that this strategy will work do.

14. (S) Hellman also explained that Russia's actions towards MN are only one facet of a much broader Russian energy strategy. He told his interlocutors that Russia has been using similar strong-arm tactics in many countries on Russia's periphery, including Slovakia, Hungary, Italy, Greece, Serbia, Ukraine, Azerbaijan, Georgia, Turkey, Uzbekistan, and Turkmenistan. The ultimate goal, he said, was to achieve Russian domination of the European energy business. Hellman encouraged the GOL to reach out informally to these countries and share experiences and strategies for dealing with Russian pressure on energy.

LITHUANIA'S CHOICE: FIGHT OR SURRENDER

15. (S) Hellman said that Lithuania (and MN) therefore faced a choice. As one option, Lithuania could capitulate and arrange for a way for Rosneft to take over MN. He admitted that this choice would probably cost Lithuania less in the short run. He emphasized, however, that it would turn out to be far costlier to both Lithuania and Europe over the longer

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term, because Russia would likely use this foothold inside the European Union to undercut European refined oil retailers, beginning with Poland's PKN Orlen. He said that MN's capacity for exports (only about half of its capacity is necessary to supply the markets of Lithuania, Latvia, and Estonia) meant that Russia could supply MN with crude at rock-bottom prices that would allow the refinery to undercut retail prices in other markets, starting with Poland. Once PKN Orlen found itself unable to compete with a Russian-owned MN, Hellman surmised, PKN Orlen's value would drop, creating an opportunity for a Russian firm to take it over. With Poland in the bag, Hellman said, the German market would be the next target. The end result: customers in Lithuania and elsewhere would end up subject to the whims of a Russian energy monopoly that controlled both supply and distribution.

16. (S) Lithuania's other alternative, according to Hellman, would be to fight by demonstrating that MN can function perfectly well without the pipeline. This strategy, Hellman cautioned, could prove expensive in the short run, but had a very good chance of succeeding, and would likely prove less expensive over the long run than the capitulation option. Once MN established itself as a successful economic entity without the pipeline, Hellman said, the internal debate among Russia's oil elite would shift in favor of its more enlightened members, leading eventually to the possibility for Lithuania and/or PKN to cut some kind of deal to restore the flow through the pipeline.

TACTICS FOR THE FIGHT

17. (S) Hellman suggested several tactics that the GOL and MN should pursue, should they choose to fight:

-- Take all necessary steps to ensure that MN can be supplied effectively via its Butinge terminal, including constructing

additional storage facilities (a typical tanker-supplied refinery would have ten times the storage capacity MN has now, according to Hellman);

-- Understand that MN may need to supply itself solely via Butinge for an indefinite period -- at least for the next 6-18 months;

-- Expect that Russia will also move to prevent MN from obtaining crude via tanker from Primorsk; this means that MN needs to enhance its trading expertise so that it can more efficiently obtain the non-Russian crude available in the Northern European market;

-- Enhance the refinery's ability to operate effectively using different types and blends of crude (to date, MN has only operated only on Urals crude);

-- Upgrade physical security and safety procedures at MN -- and especially at Butinge -- to guard against sabotage and accidental oil spills;

-- Ensure (including through bookkeeping legerdemain) that MN remains profitable, so that Lithuania will be negotiating from a position of strength when the time is right to discuss the issue with the Russians;

-- Follow a public relations strategy that emphasizes a constructive Lithuanian-Russian joint effort to address the pipeline supply problem and avoid any suggestion that the "accident" is anything other than an unfortunate mishap;

-- Emphasize close GOL/MN cooperation to ensure that bureaucratic bottlenecks do not hamper MN's ability to function effectively, for example, by expediting the process of issuing the licenses necessary to build additional storage capabilities;

-- Recognize that Russia will be losing the capacity to export approximately 500,000 barrels of crude per day

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(250,000 to MN and 250,000 to export via Butinge, worth a total of about USD 15 million) and that this will depress its own domestic market, causing real pain for many in the oil business there; and

-- Urge the European Commission's DG-Competition to consider expeditiously PKN Orlen's application for approval to purchase MN so that PKN can complete this transaction as soon as possible.

18. (S) Hellman said that if Lithuania successfully implements these tactics, the Russians should be willing -- probably in 6-18 months -- to start talking indirectly about how to reopen supplies to MN via pipeline. At that point, he said, Lithuania (and MN and perhaps PKN) will need to decide whether or not they will be willing to pay the price the Russians will demand, which will likely consist of a few billion dollars for "repairs" to the pipeline and lucrative contracts with, or side payments to, various businesses with close ties to key decision makers.

PKN NEEDS TO STAY ON THE SIDELINES, FOR NOW

19. (C) Hellman said that PKN will be unable to provide any real assistance to Lithuania or MN at present. To do so, he said, would violate EU anti-competition rules, virtually guaranteeing that DG-Competition would reject PKN's purchase of MN.

GOL RESPONSE: NO SURRENDER

¶10. (S) Hellman met with all the key Lithuanian players on this issue. Their initial reactions suggest that the GOL is unlikely to hand over MN to the Russians. Saulius Specius, advisor to the Prime Minister and one of the GOL's negotiators on the sale of MN to PKN, said that there was no legal way at this point to hand over the refinery to the Russians, even if the GOL wanted to. Simonas Satunas and Nerijus Udrenas, who advise President Adamkus on foreign policy and economic issues, respectively, also suggested that the GOL was unlikely to capitulate, especially if there were a realistic chance for MN to supply itself effectively via Butinge.

¶11. (S) Hellman swayed Albinas Januska, an MFA Under Secretary and one of the country's top foreign policy and

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national security strategists. Januska intimated that the GOL intended to go public about Russian machinations in order to bolster the Polish-Lithuanian case for a Common Energy Policy in the EU. After hearing Hellman's pitch, however, he said he was "convinced" that the GOL should follow the approach outlined above. Januska asked, and Hellman agreed, to stay in touch with Hellman, and asked him to return to Lithuania in September if necessary.

¶12. (S) Januska also added some interesting information about the end-game of MN's sale earlier this year. He said that Kazakh leader Nazarbayev called then-PM Brazauskas several times in early 2006 to try to sway him to sell MN to KazMunayGaz. Last May, four days before a New York Bankruptcy Court ruling on Yukos assets cleared the way for the sale, Putin called Nazarbayev and convinced him to pull KazMunayGaz out of the competition. Januska said that KazMunayGaz officials pleaded with Brazauskas to call Nazarbayev to allow them to carry on with the competition, but he declined, arguing that Nazarbayev would not defy Putin over an issue of this magnitude. .

¶13. (S) We detected one exception to the impulse to resist Russian pressure. The outlier was Under Secretary Anicetas Ignotas at the Ministry of Economy. Ignotas told Hellman that he believed that MN would be unable to supply itself via Butinge and still operate effectively. While he expressed the hope that PKN would be able to find a way to complete its

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purchase of MN and be successful. He said that he was resigned, however, to the fact that Lithuania would always be vulnerable to Russia on energy issues and that Lithuania therefore needed to maintain good relations with its large neighbor. (Note: Ignotas usually does not cover MN issues, but he is covering the portfolio due to a recent resignation. We expect Vytautas Nauduzas, currently Ambassador to Turkey and known to be close to Januska, will take over this portfolio at the Ministry in early September.)

MN'S RESPONSES

¶14. (C) MN officials, including General Director Nelson English and Chairman of the Board Nerijus Eidukevicius, assured Hellman that MN was fully capable of supplying itself via Butinge. They said that Butinge had a theoretical capacity to offload about 12 million tons/year, but considerations of weather and sea conditions in the Baltic (Butinge cannot offload if waves are 1.5 meters or higher) meant that 10 million tons/year was a more realistic estimate. They said that this capacity exceeded MN's projected annual needs, which they estimated at 8.6 million tons for 2006.

¶15. (C) English said that MN had already lined up seven tankers (carrying approximately 100,000 tons of crude each)

for August and another eight or nine for September, all delivering Urals crude loaded in Primorsk. Offloading each ship, he added, took about 28-30 hours. Delivery of these supplies, he said, would keep the refinery going at full capacity. He added that MN's calculations indicated that this method of delivery was approximately USD 2.50/barrel more expensive than pipeline-delivered oil, but still allowed the refinery to remain comfortably profitable.

¶16. (C) Addressing Hellman's concerns about MN's lack of adequate storage, English said that this was a problem and that MN and Butinge together had the capacity to store only about 10-12 days-worth of crude (340,000 tons), if the refinery was operating at capacity. English added, however, that Butinge already had a foundation laid for an additional 50,000-ton storage tank and that it would take approximately six months to construct if MN decided to move ahead with the project. MN currently has no plans to expand its storage capacity beyond that.

¶17. (C) English said he recognized the possibility that the Russians could also cut off MN from Russian crude loaded at Primorsk, but that as this is MN's most economic option (after the pipeline), MN will continue buying from Primorsk as long as possible. Several Russian producers, he said, were obviously nervous about doing business with MN, presumably because of their concern that they would come under pressure from the Kremlin to cancel their contracts with the refinery.

¶18. (C) English said that he was still exploring the options of obtaining crude from Venezuela, Libya, and elsewhere (ref B), but had nothing firm yet. He noted that the Venezuelan deal could result in an arrangement to supply nearly a quarter of MN's annual needs at a price comparable to what MN was paying for pipeline-delivered Urals crude, but that he still considered this a long shot.

BUTINGE NEEDS TO REPLACE DAMAGED BUOY

¶19. (C) English explained that MN plan to replace its damaged buoy at Butinge in September, a process that he expects to take 12-14 days, if the weather cooperates. During this time, he said, the terminal will be unable to offload any crude. MN plans, however, to stock up as much crude as possible before the repairs begin and have tankers ready to offload as soon as the new buoy is in place.

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COMMENT

¶20. (S) Hellman's visit -- using a top industry expert with a USG security clearance to help an ally navigate an economic-commercial crisis with national security implications -- was transformational diplomacy in action. It will empower to GOL to react soberly and intelligently to the cutoff of pipeline-delivered crude. Hellman's interlocutors were impressed by his depth of understanding of the key issues, scribbling furiously (along with us) to note his suggestions and ideas.

¶21. (S) The GOL and MN will ultimately have to decide for themselves how to proceed, but there is no doubt that Hellman's visit demonstrated tangible, credible, and much-appreciated USG support for Lithuania in a moment of need. That said, even if the Lithuanians can implement many of Hellman's suggestions, the GOL will have an increasingly difficult time avoiding pointed questions about the "accident." The press is already starting to question this explanation and the newly-formed, minority government may come under increasing attack from the conservative,

anti-Russian opposition if it continues to characterize the cutoff as a mere accident.

¶22. (S) We do not expect the Lithuanians to capitulate -- at least not yet. MN will make every attempt to supply itself via Butinge and operate profitably. If it should fail, however, we assess that it is not realistic to expect Lithuania to let its largest economic enterprise simply sit and rust. Lithuania has allowed the Russians to buy MN before, when Yukos took over from Williams International. While it would be the first choice of almost no one here, there is always the chance that MN could become Russian again.

¶23. (C) Steve Hellman did not have the opportunity to clear this cable.

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